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No. 384

In the Supreme Court of the United States

OCTOBER TERM, 1947

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SOUTH TEXAS LUMBER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

INDEX

CITATIONS

Cases:

Statutes—Continued

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OPINIONS BELOW

The opinion of the Tax Court (R. 30–35) is reported in 7 T. C. 669. The opinions in the Circuit Court of Appeals (R. 51–54) are reported in 162 F. 2d 866.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 3, 1947. (R. 54.) The petition for a writ of certiorari was filed October 3, 1947, and was granted November 24, 1947 (R. 56). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial

Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer reports (for excess profits tax as well as income tax purposes) its gains from sales of real estate upon the installment basis under Section 44 of the Internal Revenue Code, whereby such gains are reported and taxed only to the extent that they are reflected in installments actually received by the taxpayer.

The question presented is whether the taxpayer may, in computing its excess profits credit for 1943, include in its equity invested capital the uncollected and unreported profits from such installment sales, on the theory that they represent "accumulated earnings and profits" under Section 718 (a) (4) of the Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent statute and Treasury Regulations are set out in the Appendix, *infra*, pp. 34–48.

STATEMENT

The Tax Court found the facts as stipulated (R. 31–34) which, so far as material here, are as follows:

South Texas Lumber Company, hereinafter referred to as the taxpayer, is a corporation organized on September 17, 1902, under the laws of the State of Texas with its principal place of business as a retail dealer in lumber and building material located in Houston. It keeps its

books and files its income and excess profits tax returns on the calendar year and accrual basis. (R. 31.)

During the course of its business life, the taxpayer acquired title to certain real estate situated in the State of Texas. Beginning with the taxable year 1937, the taxpayer has made sales of portions of such real estate and, in accordance with Section 44 (b) of the Internal Revenue Code, has elected to compute and report the profit thereon on the installment basis. In each of the transactions where the taxpayer made such real estate installment sales, deeds were given to purchasers, and the deferred payments were evidenced by promissory notes executed by the purchaser, payable to the order of the taxpayer as therein shown, and were secured by vendor's lien and mortgage lien against the land. The taxpayer, being on the accrual basis of accounting, carried on its books as receivables all of the installment obligations so received by it from such sales. (R. 31.)

At the time provided by law, the taxpayer filed corporation income tax (Form 1120) and corporation excess profits tax (Form 1121) returns for the calendar years 1941, 1942 and 1943, disclosing net income and income taxes due thereon for the three years and excess profits tax for the calendar year 1943. In arriving at the net income for the three years, the taxpayer re-

ported the following realized profits on the installment sales referred to above (R. 33):

	1941	1942	1943
1937 sales	$3,043.49	$2,136.34	$2,396.87
1938 sales	903.70	1,135.81	403.13
1941 sales	21.84	196.56	190.98
Total	3,969.03	3,468.71	2,990.98

The balance sheets attached to and made a part of the income tax returns disclosed the following unreported income from installment sales classified as "Unrealized Profit Installment Sales" (R. 33):

	12-31-40	12-31-41	12-31-42	12-31-43
1937	$8,541.39	$5,497.90	$3,361.56	$964.69
1938	2,442.64	1,538.94	403.13	0
1941	0	1,070.36	873.80	682.82
Total	10,984.03	8,107.20	4,638.49	1,647.51

In its corporation excess profits tax return, Form 1121, for the calendar year 1943, the taxpayer claimed the unreported income from installment sales, $4,638.49 as at December 31, 1942, as a part of surplus and undivided profits in arriving at its equity invested capital. It also claimed the unreported income from installment sales, $10,984.03 as at December 31, 1940, and $8,107.20 as at December 31, 1941, in arriving at its equity invested capital for the calendar years 1941 and 1942, respectively, for the purpose of its unused excess profits credit carryover from the

calendar years 1941 and 1942 to the calendar year 1943. (R. 33–34.)

The tax in controversy in this case is the excess profits tax for the calendar year 1943. The Commissioner, as disclosed by the statutory notice of deficiency dated November 5, 1945, reduced the taxpayer's equity invested capital for the calendar years 1941, 1942 and 1943 by the amounts of unreported profits from installment sales previously referred to above in the respective amounts of $10,984.03, $8,107.20 and $4,638.49. (R. 34.)

The Tax Court sustained the Commissioner's determination (R. 35), but the court below reversed the Tax Court's decision (R. 54).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the taxpayer, which reported its profits from sales of real estate for income and excess profits tax for the taxable year 1943 on the installment basis of return under Section 44 (b) of the Internal Revenue Code, may for excess profits tax purposes include in its equity invested capital uncollected and unreported profits from such installment sales of real estate outstanding on its books as of January 1, 1941, 1942, and 1943, on the theory that these profits represent "accumulated earnings and profits as

of the beginning of such taxable year," under Section 718 (a) (4) of the Code.

(2) In failing to hold that subsection (l) of Section 115, defining "earnings and profits," is applicable to a determination of the taxpayer's "accumulated earnings and profits as of the beginning of such taxable year" under Section 718 (a) (4) for the purpose of computing its equity invested capital for excess profits credit purposes.

(3) In failing to apply Section 29.115–3 and Section 29.115–12 of Treasury Regulations 111, promulgated under the income tax provisions of the Code, and Section 35.718–2 of Treasury Regulations 112, promulgated under the excess profits tax provisions thereof, in the determination of the taxpayer's "accumulated earnings and profits as of the beginning of such taxable year," in computing its equity invested capital for excess profits credit purposes under Section 718 (a) (4).

(4) In failing to hold that uncollected and unreported profits of the taxpayer on installment sales are not "recognized" for tax purposes under Sections 44, 111, and 112 of the Internal Revenue Code and may not be included in "accumulated earnings and profits" under Section 718 (a) (4).

(5) In reversing the Tax Court's decision.

SUMMARY OF ARGUMENT

The taxpayer, although reporting gain from installment sales upon the installment basis, as provided for in Section 44 of the Internal Revenue Code, for purposes of both the income tax and

the excess profits tax, seeks to disregard that basis in computing its "accumulated earnings and profits" which enter into the computation of equity invested capital under Section 718 (a) (4) of the Code. This is directly contrary to Treasury Regulations which provide that the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing net income and which specifically direct that a corporation computing income on the installment basis as provided in Section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis. Section 29.115–3, Regulations 111.

These Regulations are valid and should be sustained. (1) They are in accord with numerous decisions rendered under the excess profits tax provisions of the Revenue Act of 1918 which held that uncollected gains on installment sales in the case of taxpayers reporting on the installment basis are not to be included in earnings of the taxpayer for the purpose of determining "earned surplus and undivided profits," which was one of the elements of invested capital under that Act. (2) The same principles which led this Court in *Commissioner* v. *Wheeler*, 324 U. S. 542, to sustain a portion of the Regulations here pertinent require the conclusion that these Regulations are valid. (3) The installment basis of return of gain from sales of property is an

approved, independent statutory method of return, and it is an established principle that the same method employed in computing and reporting gains for income tax purposes must be used in determining earnings and profits. (4) Section 115 (l) and Sections 111 and 112 of the code support the validity of the Regulations. Section 115 (l) provides, among other things, that realized gain or loss "shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made." Sections 111 and 112 deal with the determination of the amount of, and the recognition of, gain or loss.

It is apparent that, with respect to the time when realized and recognized gain shall enter into the computation of net income and into the computation of earnings and profits, Sections 111 and 112 are superimposed upon the methods of accounting provided for in Sections 41 to 44, inclusive. Under Section 44, pertaining to the installment basis, gains are realized and recognized when installment payments are actually received in cash. Since under that basis the taxpayer's uncollected profits on installment sales are not deemed to have been realized and recognized for the purpose of computing net income, they may not enter into the computation of the

taxpayer's "accumulated earnings and profits" within the meaning of Section 718 (a) (4).

The court below, in holding that the taxpayer's accumulated earnings and profits should be increased by the amount of its uncollected profits on installment sales, has erroneously construed Section 115 (l) and has erroneously refused to give proper effect to valid Regulations of the Treasury Department.

ARGUMENT

THE TAXPAYER MAKING ITS RETURNS ON THE INSTALLMENT BASIS UNDER SECTION 44 OF THE INTERNAL REVENUE CODE MAY NOT INCLUDE IN ITS EQUITY INVESTED CAPITAL UNDER SECTION 718 (a) (4) OF THE CODE UNCOLLECTED PROFITS FROM SUCH SALES

Introductory

In the taxable year 1943, and in years prior thereto, the taxpayer's income from installment sales was reported by it on the installment basis under Section 44 (a) and (b) of the Internal Revenue Code (Appendix, *infra,* p. 36), both for purposes of income tax and excess profits tax. Under the installment basis, as provided for in Section 44, a taxpayer returns as income in any taxable year that portion of installment payments actually received in that year which the gross profit realized or to be realized from a sale bears to the total contract price. Thus, in the taxable year 1943, and in prior years, the taxpayer has included in the computation of income, for excess profits tax purposes, as well as for income tax

purposes, gains from installment sales only to the extent that such gains were represented in installment payments actually received by it in cash, and the taxpayer was not required to and in fact did not report as income for either income or excess profits tax purposes any gains on its sales that were attributable to installments which it had not yet received.

At the beginning of the years 1941, 1942 and 1943, the uncollected and untaxed profits on installment sales made by the taxpayer aggregated the respective amounts of $10,984.03, $8,107.20, and $4,638.49. In its corporation excess profits tax return for the calendar year 1943, the taxpayer, in arriving at its equity invested capital,[1] included the unreported income from installment sales as of the beginning of that year ($4,638.49) as part of its "accumulated earnings and profits as of the beginning of such taxable year" within the meaning of Section 718 (a) (4) (Appendix *infra*, p. 43). It also included the unreported profits from installment sales as at January 1, 1941, and as at January 1, 1942 (amounting, respectively, to $10,984.03 and $8,107.20), in arriv-

[1] The excess profits tax is imposed with respect to profits in excess of a specified credit, and that credit may be based upon the stated percentages of the corporation's "invested capital." Sections 710, 711, 712 and 714. The invested capital is defined to consist of the sum of the corporation's "equity invested capital" and its "borrowed invested capital." Section 717. Section 718 spells out in detail the method of computing "equity invested capital."

ing at its equity invested capital for the calendar years 1941 and 1942, respectively, for the purpose of its unused excess profits credit carryover from the years 1941 and 1942 to the taxable year 1943, here involved, allowed under Section 710 (b) (3). The Commissioner eliminated the items of uncollected and unreported profits from taxpayer's "accumulated earnings and profits" in arriving at taxpayer's equity invested capital, and accordingly determined a deficiency in excess profits tax for the year 1943.

The sole question presented is whether the term "accumulated earnings and profits" used in Section 718 (a) (4) of the Code embraces uncollected and unreported profits from installment sales of a taxpayer which employs for both income and excess profits tax purposes the installment method of reporting provided for in Section 44. The Tax Court sustained the Commissioner's determination on the authority of its own decision in the case of *Kimbrell's Home Furnishings, Inc.* v. *Commissioner*, 7 T. C. 339.[2] The Circuit Court

[2] The *Kimbrell's* case was subsequently reversed by the Circuit Court of Appeals for the Fourth Circuit (159 F. 2d 608). The installment basis taxpayer in that case had elected under Section 736 (a), added to the Internal Revenue Code by Section 222 (d) of the Revenue Act of 1942, c. 619, 56 Stat. 798, to compute its income from installment sales upon the *accrual basis* for purposes of the excess profits tax, while the taxpayer in the present case has remained on the installment basis for both income and excess profits tax purposes. The Tax Court's decision in favor of the Commissioner in that case was based upon the propositions (1) that a taxpayer re-

of Appeals for the Fifth Circuit reversed on the authority of its earlier decision in *Commissioner* v. *Shenandoah Co.*, 138 F. 2d 792.

The case of *Commissioner* v. *Shenandoah Co.*, like the present case, involved a taxpayer generally upon the accrual basis, but which employed the installment basis under Section 44 for reporting its income from installment sales. Unlike the present case, the *Shenandoah Co.* case did not involve the excess profits tax or the meaning of "accumulated earnings and profits" as used in Section 718 (a) (4) of the Code, but rather the question whether uncollected and unreported

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porting upon the installment basis may not include in "accumulated earnings and profits" items of uncollected and unreported profits, and (2) that neither the wording nor the legislative history of Section 736 (a) warranted the conclusion that Congress intended an election under it to bring into accumulated earnings an item which prior thereto was not so includible. The Circuit Court of Appeals disagreed with the Tax Court only as to proposition (2). It reversed upon the ground that, since the taxpayer there reported upon the accrual basis for purposes of the excess profits tax, uncollected profits on installment sales were "recognized," as well as realized (p. 612)—"because they are taken into consideration in computing the part of the sales price to be included in the excess profit net income and subjected to the excess profits tax."

In short, by taking advantage of the option under Section 736 (a), the taxpayer in the *Kimbrell's* case was permitted to abandon the installment basis of accounting for excess profits tax purposes, but was also required to accrue its gains in the years the sales were made. Such gains, unlike the gains herein, were thus in fact *recognized* for excess profits tax purposes and were therefore included in the corporation's earnings and profits.

profits from installment sales might be included in "earnings and profits" available for the payment of dividends within the meaning of Section 115 (a) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, which subsequently became Section 115 (a) of the Code. However, insofar as the question in the present case is concerned, neither the Tax Court, the Circuit Court of Appeals, the taxpayer, nor the Commissioner has suggested any difference in meaning between the term "accumulated earnings and profits" as used in Section 718 (a) (4) and the meaning of that term as used in Section 115 (a). The Treasury Regulations (Treasury Regulations 112, Section 35.718–2, Appendix, *infra,* p. 47) provide that in general the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax, and Section 728 of the Code (Appendix, *infra,* p. 44), as well as the legislative history of Section 115 (1) of the Code (Appendix, *infra,* p. 39), attest the correctness of that conclusion.[3]

[3] See Report of a Subcommittee of the House Committee on Ways and Means, 76th Cong., 3d Sess., p. 14, on "Proposed Excess-Profits Taxation and Special Amortization—1940" (G. P. O. 1940); H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41–43 (1940–2 Cum. Bull. 496, 526–527). See also subsections (a) (3), (5) and (7), (b) (1), (2), (3) and (5), and (c) (1), (3) and (5) of Section 718 of the Code, and H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 59–64 (1940–2 Cum. Bull. 548, 562–566), which confirm the conclusion that the term "earnings and profits" as used in Section 718 (a) (4) is employed in its tax sense.

771666—48——3

The decision of the present case, therefore, does not turn upon any peculiarities of the excess profits tax provisions, but is controlled by principles applicable in determining "earnings and profits" in the federal tax sense, as those principles are laid down in the applicable Treasury Regulations, namely, Sections 29.115–3 and 29.115–12 of Regulations 111 (Appendix, *infra*, pp. 44–47).

The ultimate question in the case therefore is as to the validity of these Regulations.

A. THE PERTINENT REGULATIONS SPECIFICALLY COVER THIS CASE

Section 29.115–3 of Regulations 111 (Appendix, *infra*, pp. 44–45, provides as follows:

> SEC. 29.115–3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and

profits; *a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis;* and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204 (b) (3) and which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) or corresponding provisions of prior Revenue Acts. *Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115–12).*

* * * [Italics supplied.]

The provision of the above-quoted Regulations, that a corporation computing income on the installment basis as provided in Section 44 shall with respect to the installment transactions compute earnings and profits on such basis, specifically covers this case. These Regulations by their express terms are applicable in determining "the amount of the earnings or profits in any case."

They are, therefore, not limited to the determination of earnings and profits for a given year, or for any specific period, as contended by the taxpayer in its Brief in Opposition, p. 13. The cross-reference to these Regulations contained in Section 35.718–2 of Regulations 112 (Appendix, *infra*, p. 47), relating exclusively to the excess profits tax, leaves no doubt that these Regulations were intended to be applied in determining "accumulated earnings and profits" under Section 718 (a) (4). This is further confirmed by the provisions of Section 29.115–12 of Regulations 111, dealing with the application of Section 115 (l) of the Code relating to the effect on earnings and profits of gain or loss realized after February 28, 1913.[4] It was stipulated (R. 26) that

[4] Section 29.115–12 states that the rules for determining gain or loss under Section 115 (l) of the Code "are applicable whenever under any provision of chapter 1 [containing the ordinary income tax provisions] or 2 [containing the excess profits tax provisions] it is necessary to compute either the total earnings and profits of the corporation or * * *." And the same section also describes the total earnings and profits of a corporation as being "of most frequent application in determining invested capital," which is relevant only for excess profits tax purposes.

Thus, these provisions make it clear that the method of determining earnings and profits for excess profits purposes is the same as for ordinary income tax purposes in Section 115 (l). Furthermore, Section 728 of the Code provides that "The terms used in this subchapter [i. e., the subchapter which imposes the excess profits tax] shall have the same meaning as when used in Chapter 1 [the chapter which imposes the ordinary income taxes and which contains such provisions as Section 115]." See Appendix, *infra*, p. 44.

the taxpayer computed income with respect to its installment sales on the installment basis, as provided by Section 44. Accordingly, under the provisions of these Regulations, the taxpayer's earnings and profits must be computed on that basis.[5]

B. THE PERTINENT REGULATIONS ARE VALID

The question whether Sections 29.115–3 and 29.115–12 of Regulations 111 are valid is narrowed to a determination whether they are so obviously an improper interpretation of the statute as to require that they be stricken down. The question is not whether the administrative determination is free from doubt, but whether it is a reasonable one. *Trust of Bingham* v. *Commissioner,* 325 U. S. 365; *Brewster* v. *Gage,* 280 U. S. 327; *Fawcus Machine Co.* v. *United States,* 282 U. S. 375. The decisions involving a comparable issue under the Revenue Act of 1918 to that here presented; the decision of this Court in *Commissioner* v. *Wheeler,* 324 U. S. 542; the development of the installment basis as a separate method of returning gain from installment sales; the decisions requiring that the same method of computing and reporting gains for income tax purposes

[5] It is, of course, irrelevant that the taxpayer keeps its books and makes its return of other income upon the accrual basis, and as a bookkeeping matter accrues the gain from installment sales in the year in which they are made. Moreover, the taxpayer has not contended that the fact that it accrued the unreported profits from its installment sales on its books has any bearing on the question here presented.

be followed in determining earnings and profits; the provisions and legislative history of Section 115 (l) of the Code; and the provisions of Sections 111 and 112 of the Code—all support the validity of the Regulations.

1. *The decisions under the excess profits tax provisions of the Revenue Act of 1918*

As indicated above (p. 17), a similar issue arose on numerous occasions under Section 326 (a) (3) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057) with respect to the war-profits and excess-profits tax then in effect. That provision read as follows:

> SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):
>
> * * * * *
>
> (3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;
>
> * * *

Although the language of this section is not identical with Section 718 (a) (4) of the Code, here involved, the provisions of both sections in effect require the inclusion of accumulated earnings and profits in invested capital, and under the 1918 Act, it was uniformly held that uncollected gains on installment sales in the case of taxpayers reporting on the installment basis were not to be included in earnings of the taxpayer for the pur-

pose of determining its invested capital. See e. g., *Schmoller & Mueller Piano Co.* v. *United States*, 67 C. Cls. 428; *John M. Brant Co.* v. *United States*, 40 F. 2d 126 (C. Cls.), certiorari denied, 282 U. S. 888; *Standard Computing Scale Co.* v. *United States*, 52 F. 2d 1018 (C. Cls.); *Jacob Bros. Co.* v. *Commissioner*, 50 F. 2d 394 (C. C. A. 2d); *Tull & Gibbs* v. *United States*, 48 F. 2d 148 (C. C. A. 9th). The decisions of the Board of Tax Appeals are to the same effect. See e. g., *Blum's Inc.* v. *Commissioner*, 7 B. T. A. 737, 771; *S. Davidson & Bros.* v. *Commissioner*, 21 B. T. A. 638, 644; also *Federal St. & Pleasant Valley Passenger Ry. Co.* v. *Commissioner*, 24 B. T. A. 262, 266.

Thus, at the outset, there appears ample historical justification for an application of this principle to the excess profits tax provisions of the Code.

2. *The decision of this Court in* Commissioner *v.* Wheeler *supports the validity of these Regulations*

The last sentence (italicized) of Section 29.115–3 of Regulation 111 quoted above, supra, p. 15, is as it appeared in Article 115–3 of Regulations 101, defining earnings and profits which was considered and approved by this Court in the case of *Commissioner* v. *Wheeler*, 324 U. S. 542. This portion of the Regulations provides for both the time when and the extent to which such gains and

losses shall be brought into the earnings and profits. While the *Wheeler* case involved the basis for determining earnings and profits of securities in the hands of a corporation acquired by it in a non-taxable exchange, that question had implicit in it both the extent to which and the time when gains from a transaction are to be brought into earnings and profits. The Court held the Regulations to be valid and based its decision thereon. It is true that the portion of the Regulations (Section 29.115–3) which provides that the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing net income and the portion thereof which provides that a corporation computing income on the installment basis, as provided in Section 44, shall, with respect to the installment transactions, compute earnings and profits on such basis, were not contained in the Regulations approved by this Court in that case. Nevertheless, the same principles which led the Court to uphold the validity of the portion of the Regulations there involved require that the additional portions of Regulations here in question be sustained.*

In the *Wheeler* case, the Court held that the same policy which carried over the transferor's

*These provisions of Section 29.115–3 involving the method of return in the computation of earnings and profits were added by way of an amendment to Section 19.115–3 of Regulations 103, in T. D. 5059, 1941–2 Cum. Bull. 125.

basis for purposes of the corporation's income tax required carrying it over for determining the corporation's earnings and profits. The holding of the Court thus correlates not only the extent to which, but the time when, gain shall be brought into earnings and profits with the extent to which and the time when such gain shall enter into the computation of net income. It would seem necessarily to follow that the same correlation is required in the method employed in computing net income and earnings and profits on any basis of accounting recognized for purposes of taxation.

3. *The installment basis of return of gain from sales of property is a separate and independent statutory method of return*

Prior to the Revenue Act of 1926, c. 27, 44 Stat. 9, there was no express provision for the installment method of return. However, such method had been provided for prior thereto by the Regulations, originally by Article 117 of Regulations 33 (Revised), promulgated January 2, 1918, and this was followed by Article 42 of Regulations 45, promulgated April 17, 1919. These Regulations, particularly Article 42 of Regulations 45, not only established and defined the "installment basis" of return, but provided for that basis as an additional one to the cash and accrual methods of making returns. Thus these Regulations did not prohibit such return to be made upon either of the other two bases.

These Regulations were, however, in the absence of supporting legislation, held invalid in 1925 by the Board of Tax Appeals in a series of cases,[1] and in response thereto Congress enacted Section 212 (d) of the 1926 Act, now subsections (a) and (b) of Section 44 of the Code. It is to be noted that Congress regarded such basis of return as having already received its implied approval in Section 202 (f) of the Revenue Act of 1921, c. 136, 42 Stat. 227, which is now Section 111 (d) of the Code, and, moreover, that it regarded such method as contributing a *third* basis of return. Thus, it was stated in S. Rep. No. 52, 69th Cong., 1st Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 332, 346):

> SECTION 212 (d). The revenue act of 1924 and prior acts have specifically provided two bases only for reporting income—first, cash receipts and disbursements, and, second, accrual. Since the enactment of the revenue act of 1921, however, *Section 202 (f) and its successors have impliedly recognized the existence of a third basis, the installment basis,* without in any wise defining the situations and businesses to which such basis might be applied. The Commissioner of Internal Revenue has in his regu-

[1] See particularly *Todd* v. *Commissioner*, 1 B. T. A. 762; also *H. B. Graves Co.* v. *Commissioner*, 1 B. T. A. 859; *Hoover-Bond Co.* v. *Commissioner*, 1 B. T. A. 929; *Six Hundred and Fifty West End Avenue Co.* v. *Commissioner*, 2 B. T. A. 958.

lations provided, in pursuance of his authority to require a method of computation that will clearly reflect income, the installment basis for reporting income in certain cases.[8] [Italics supplied.]

The decisions under the Revenue Act of 1918, *supra*, p. 19, support the view that the installment basis of accounting, thus expressly recognized by law, constituted a third basis of return and was a separate and independent method of accounting and one that is coequal with the cash and accrual bases (now provided for by Sections 41 to 43 of the Code (Appendix, *infra*, pp. 34–35)), insofar as it permits the return of gains from installment sales pursuant thereto.

4. *It is an established principle that the same method employed in computing and reporting gains for income tax purposes must be used in determining earnings and profits*

Even prior to the decision of this Court in the *Wheeler* case, it was an established principle that the same method employed in computing and reporting gains for income tax purposes must be used in determining earnings and profits. See G. C. M. 2951, VII–1 Cum. Bull. 160 (1928); I. T. 3253, 1939–1 Cum. Bull. 178; *Helvering* v. *Alworth*

[8] For an exhaustive review of the history of the taxation of installment sales, see *Blum's, Inc.* v. *Commissioner*, 7 B. T. A. 737, 751 *et seq.*; as also *Willcuts* v. *Gradwohl*, 58 F. 2d 587, 590 *et seq.* (C. C. A. 8th).

Trust, 136 F. 2d 812 (C. C. A. 8th), certiorari denied, 320 U. S. 784; *Siegel* v. *Commissioner*, 29 B. T. A. 1289, 1293; *Neptune Meter Co.* v. *Price*, 98 F. 2d 76 (C. C. A. 2d); *Wells Fargo Bank & Union Trust Co.* v. *McLaughlin*, 78 F. 2d 934 (C. C. A. 9th), certiorari denied, 296 U. S. 638.

In the *Alworth Trust* case, *supra*, it was held that earnings and profits in the taxable year of a taxpayer upon the cash basis were not diminished by the amount of federal taxes which had not been paid or accrued by the corporation in that year, even though imposed upon the earnings for that year.[9] Cf. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 366. The decisions under the Revenue Act of 1918, *supra*, p. 19, rest upon the principle that the same method was required to be used in the case of taxpayers on the installment basis of return in computing earnings and profits as was used in computing net income. Thus, in *Jacob Bros. Co.* v. *Commissioner*, *supra*, (50 F. 2d, p. 396) the Second Circuit said that the installment basis of return was in effect accounting on the cash basis (though, of course, not the conventional one) for both the purposes of computing net income and for that of computing earnings and profits.

[9] See Rudick, *"Dividends" and "Earnings or Profits" under the Income Tax Law: Corporate Nonliquidating Distributions*, 89 U. Pa. L. Rev. 865, 878-879 (1941).

5. *Section 115 (l) of the Code justifies the provisions of Section 29.115–3 of Regulations 111*

Section 115 (l) of the Code (added by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974), after describing the method of determining gain or loss from the sale of property by a corporation, for the purpose of computing its "earnings and profits," explicitly provides:

> Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made.

In explanation of the amendment which added subsection (l) to Section 115, the Ways and Means Committee of the House made the following statement in its report, H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum. Bull. 496, 526):

> SECTION 401 [501] EARNINGS AND PROFITS OF CORPORATIONS
>
> The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also

in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (l) in section 115 of the Internal Revenue Code and correspondingly amends prior revenue acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome*, 60 F. 2d 931, and following decisions, the rule effectuates the provisions of section 112. While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, *even though not recognized in computing net income*, nevertheless affects earnings and profits.[10] * * * [Italics supplied.]

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[10] As explicitly appears from this report (p. 42), one of the purposes of the amendment was to overrule the principle applied in the case of *Commissioner* v. *F. J. Young Corp.*, 103 F. 2d 137 (C. C. A. 3d), and similar holdings. But it was upon the theory of that line of cases that the decision of the court in the *Shenandoah Co.* case (*supra*, p. 12) was rested, at least in part. See also the unreported decision of the Tax

Thus, the language of Section 115 (l) as explained in the foregoing report clearly evidences a Congressional purpose to provide that, until gain is recognized in the computation of net income, it will not affect earnings and profits. As stated in the report, earnings and profits are increased or diminished only by the amount of the recognized gain or loss, computed in accordance with Sections 111, 112 and 113.

It is true that Section 115 (l) refers to the gain or loss recognized in computing net income "under the law applicable to the year in which such sale or disposition was made," and the taxpayer argued in its brief in opposition (pp. 3–4, 9) that this language means that, unless the gain is recognized in the year of sale, it cannot enter into the computation of earnings and profits.

The error in this contention lies in the fact that the foregoing provision merely fixes the law in effect during the year of sale as being controlling in the determination of earnings and profits. It does not require that the gain be brought into

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Court in that case, 1943 P–H T. C. Memorandum Decisions, par. 43,028, promulgated January 16, 1943. At the time of the Tax Court's decision in the *Shenandoah Co.* case, Section 115 (l) had been added to the Code, but was apparently overlooked by the judge who decided the case. On the other hand, within thirty days after the decision in the *Shenandoah* case, another judge of the Tax Court in deciding the case of *Wheeler* v. *Commissioner*, 1 T. C. 640, held that the *Young* and the other cases involving similar holdings had been overruled by Congress in its enactment of Section 115 (l).

earnings and profits in such year. And indeed, the law in effect in the year of sale may require that the gain be brought into earnings and profits in some other year. This is made clear by Section 29.115–12 of Regulations 111, which provides:

> As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. * * *

Thus, the provisions of Sections 44 and 111, as well as 112, all of which constitute parts of a comprehensive and interrelated system, are brought into play here.

Section 112 (a) announces the general rule as to *recognition* of gain or loss upon the sale or exchange of property, and it refers to Section 111 for the purpose of determining the amount of gain or loss. Section 111 (a) and (b) establish the general rule for computing the gain or loss, Section 111 (c) makes a general cross reference to Section 112 as to recognition, and, finally, Section 111 (d) deals specifically with installment sales. Section 111 (d) provides that nothing in Section 111 shall be construed to prevent, in the case of installment sales (that is, sales under Section 44):

> the taxation of that portion of any installment payment representing gain or profit

in the year in which such payment is received.

In the first place, the word "taxation" is no doubt the broadest one which could have been used in this connection. For it contemplates not only the impostion of the tax, but every step necessary thereto, including the computation of net income.

In the second place, the word "taxation" as used in Section 111 (d) refers to "that portion of any installment payment representing gain or profit in the year in which such payment is received." This language clearly indicates that each installment payment embraces a portion of the total gain or profit to be derived from the sale and that such gain or profit is derived in the year in which such payment is received, not necessarily in the year the sale is completed. This accords with the Section 44 concept of return. Accordingly, Section 111 (d) clearly requires the recognition of gain from installment sales to be determined for all purposes in accordance with the method provided for in Section 44 (a).

Moreover, it is apparent that Sections 111 and 112 are superimposed upon the general provisions of Sections 41 to 44, inclusive, relating to the various methods of reporting income. Thus, subsection (a) of Section 111 provides that the gain from the sale or the disposition of property shall be the excess of the "amount realized" over

the adjusted basis provided in Section 113 (b) for determining gain, and subsection (b) of Section 111 provides that the "amount realized" from such sales shall be the sum of money received plus the fair market value of other property received. And, as stated, Section 112 (a) provides that upon the sale or exchange of property the entire amount of the gain or loss, determined under Section 111, shall be recognized, except as otherwise provided in the other subsections of Section 112. Thus, there is no express provision in these sections dealing with the time element for taking gain either into net income or into earnings and profits.

It is obvious, therefore, in the scheme of the statute, that the basic accounting provisions in Sections 41–44 underlie the provisions of Sections 111 and 112 for the purpose of fixing the time when the gains computed and recognized under Sections 111 and 112 shall be taken into account. For example, while Section 111 (b) defines "amount realized" as the sum of money and the fair market value of other property received, nevertheless, the entire gain from a sale derived by a taxpayer employing the accrual method of accounting would be reported in the year of sale without regard to the time when the money or other property is received. On the other hand, a taxpayer on the cash basis would report gain only in the year in which cash or other property

having a fair market value was actually received by it. The installment method of reporting, while not conforming exactly to the conventional cash method, has in common therewith that feature which requires the gain to be reckoned as of the time of receipt of cash. The installment method is unlike the cash method in that it disregards the receipt of the installment obligations themselves notwithstanding the fact that the installment obligations received, if any, may have a fair market value. Indeed, one of the purposes of establishing the installment basis of return for tax purposes was to avoid the necessity of valuing such obligations. See S. Rep. No. 52, 69th Cong., 1st Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 332, 347) already referred to (*supra*, p. 22), as also *Blum's Inc.* v. *Commissioner, supra* (7 B. T. A. at pp. 741, 757, 771) and *Willcuts* v. *Gradwohl, supra* (58 F. 2d at pp. 589–590).[11]

[11] In the court below the taxpayer cited *Lawler* v. *Commissioner*, 78 F. 2d 567 (C. C. A. 9th); *Provident Trust Co.* v. *Commissioner*, 76 F. 2d 810 (C. C. A. 3d); *Crane* v. *Helvering*, 76 F. 2d 99 (C. C. A. 2d), and *Nuckolls* v. *United States*, 76 F. 2d 357 (C. C. A. 10th), as holding that "realization" of gain from installment sales occurs in the year of sale. Those cases involved no question comparable to that here presented. There the question was with respect to the application and constitutional validity of subsection (d) of Section 44. That subsection provides that, if an installment obligation is transmitted, sold or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and its fair market value at the time of such distri-

In the court below the taxpayer emphasized the fact that there are certain instances where items are taken into account for purposes of determining earnings and profits which are not taken into account for the purpose of net income. And from this the taxpayer argued that the time element was not a relevant factor in the determination of earnings and profits. The Commissioner, of course, does not contend that "earnings and profits" conform exactly to taxable income. His Regulations (Section 29.115–3 of Regulations 111) set forth instances where there is a difference in treatment of items for the two purposes; and this Court in the *Wheeler* case (324 U. S. at 546) also adverted to this absence of exact conformity between the determination of earnings and profits and the determination of taxable income. See also H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum. Bull. 496, 526–527); S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 22–27 (1940–2 Cum. Bull. 528, 545–548), and H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 59–62 (1940–2 Cum. Bull. 548, 562–564).

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bution, transmission or disposition. It was held in those cases that there was no constitutional obstacle to the taxation of the gain so computed at the time of the sale or other disposition of the installment obligation. Those cases, rather than supporting the taxpayer's position here, support the view that neither realization nor recognition of the entire gain from the sale of the original property took place in the year of the sale of such original property but took place instead, at least in part, in the year in which the installment obligations were sold or otherwise disposed of.

However, in this case, there is no question that such gain as may be realized from the installment sales is of a character that is to be taken into account for both net income and earnings and profits purposes. As stated, the substantial controversy relates to the time when such gain is to be taken into account for earnings and profits purposes. We submit that the Tax Court properly held that the time when the gain in question should be brought into earnings and profits must coincide with the time it is brought into net income.

CONCLUSION

For the reasons stated, the decision of the court below should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code:

Chapter 1—Income Tax

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U. S. C. 1940 ed., Sec. 41.)

SEC. 42 [As amended by Section 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687, and as further amended by Section 134 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.—

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless,

under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death.

* * * * *

(26 U. S. C. 1940 ed., Sec. 42.)

SEC. 43 [As amended by Sec. 134 (b) of the Revenue Act of 1942, *supra*]. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing net income for the period in which falls the date of the taxpayer's death.

(26 U. S. C. 1940 ed., Sec. 43.)

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personality* [*sic*].—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * *

(26 U. S. C. 1940 ed., Sec. 44.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) *Installment Sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received. (26 U. S. C. 1940 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 112.)

SEC. 115. DISTRIBUTION BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock

or securities" includes rights to acquire stock or securities.

* * * * *

(l) [As added by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 1004] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

Chapter 2—Additional Income Taxes

SUBCHAPTER A—PERSONAL HOLDING COMPANIES

* * * * *

SUBCHAPTER B [as amended by Section 506 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]—DECLARED VALUE EXCESS PROFITS TAX.

* * * * *

SUBCHAPTER C—EXCESS PROFITS ON NAVY CONTRACTS

* * * * *

SUBCHAPTER D—UNJUST ENRICHMENT

* * * * *

SUBCHAPTER E—EXCESS PROFITS TAX [as added by Section 201 of the Second Revenue Act of 1940, *supra,* which provided that the new subchapter may be cited as the "Excess Profits Tax Act of 1940"].

PART I

SEC. 710. IMPOSITION OF TAX.

(a) *Imposition.*—

(1) [as amended by Section 202 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(A) 90 per centum of the adjusted excess profits net income, or

* * * * *

(b) *Definition of Adjusted Excess Profits Net Income.*—As used in this section, the term "adjusted excess profits net income"

in the case of any taxable year means the excess profits net income (as defined in Section 711) minus the sum of:

(1) [as amended by Section 205 of the Revenue Act of 1942, *supra*] *Specific Exemption.*—A specific exemption of $5,000, and in the case of a mutual insurance company (other than life or marine) which is an interinsurer or reciprocal underwriter a specific exemption of $50,000;

(2) *Excess Profits Credit.*—The amount of the excess profits credit allowed under Section 712; and

(3) [As amended by Sec. 2 (a) of the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, and Sec. 204 (a) of the Revenue Act of 1942, *supra*] *Unused Excess Profits Credit.*—The amount of the unused excess profits credit adjustment for the taxable year, computed in accordance with subsection (c).

* * * * *

(26 U. S. C. 1940 ed., Sec. 710.)

SEC. 711. EXCESS PROFITS NET INCOME.

(a) *Taxable Years beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13 (a) (2), for such year except that the following adjustments shall be made:

* * * * *

(2) *Excess Profits Credit Computed Under Invested Capital Credit.*—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * * * *

(26 U. S. C. 1940 ed., Sec. 711.)

SEC. 712 [as amended by Section 13 of the Act of March 7, 1941, c. 10, 55 Stat. 17]. EXCESS PROFITS CREDIT-ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714.

* * * * *

(26 U. S. C. 1940 ed., Sec. 712.)

SEC. 714 [As amended by Section 217, Revenue Act of 1942, *supra*]. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715, is not over $5,000,000, the credit shall be 8% of the invested capital.

* * * * *

(26 U. S. C. 1940 ed., Sec. 714.)

SEC. 715. DEFINITION OF INVESTED CAPITAL.

For the purposes of this subchapter the invested capital for any taxable year shall be the average invested capital for such year, determined under section 716, reduced by an amount computed under section 720 (relating to inadmissible assets). If the Commissioner finds that in any case the determination of invested capital, on a basis other than a daily basis,

will produce an invested capital differing by not more than $1,000 from an invested capital determined on a daily basis, he may, under regulations prescribed by him with the approval of the Secretary, provide for such determination on such other basis. (For computation of invested capital in case of foreign corporations and corporations entitled to the benefits of section 251, see section 724.)

(26 U. S. C. 1940, ed., Sec. 715.)

SEC. 716. AVERAGE INVESTED CAPITAL.

The average invested capital for any taxable year, shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year.

(26 U. S. C. 1940 ed., Sec. 716.)

SEC. 717. DAILY INVESTED CAPITAL.

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719.

(26 U. S. C. 1940 ed., Sec. 717.)

SEC. 718. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * *

(26 U. S. C. 1940 ed., Sec. 718.)

SEC. 728. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

(26 U. S. C. 1940 ed., Sec. 728.)

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

* * * * *

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.115–3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books

and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204 (b) (5) and which is segregated accordingly in the unearned premium reserve.

* * * Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115–12). * * *

* * * * * *

SEC. 29. 115–12. *Effect on Earnings and Profits of Gain or Loss Realized After February 28, 1913.*—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (l) prescribed certain rules for (1) the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are ap-

plicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. * * *

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115 (l) as distinguished from the realized gain or loss used in computing net income. The application

of this paragraph may be illustrated by the following examples: * * *

* * * * * *

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.718–2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718–5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax.[1] * * *

SEC. 35.718–6. *Determination of Daily Equity Invested Capital—Reduction by Earnings and Profits of Another Corporation.*—Section 718 (b) (3) provides for the elimination of the duplication which occurs in the computation of the equity invested capital of the taxpayer following a transaction of the character referred to therein, as a result of which the earnings and profits of another corporation became the earnings and profits of the taxpayer.[2] The earnings and profits of such other corporation having been included at the time of the trans-

[1] Substantially the same provision appeared in Section 30.718–2 of Treasury Regulations 109, promulgated in 1941 under the Internal Revenue Code as amended by the Second Revenue Act of 1940.

[2] *Commissioner* v. *Sansome*, 60 Fed. (2d) 931.

action in the earnings and profits of the taxpayer, they remain continuously thereafter a part of such earnings and profits account for the purpose of computing for any day after such transaction the earnings and profits, the accumulated earnings and profits at the beginning of the taxable year, and the earnings and profits of the taxable year. In addition, however, the amount of such included earnings and profits is also brought into computation of equity invested capital of the taxpayer under provisions of section 718 other than section 718 (a) (4) relating to accumulated earnings and profits as of the beginning of the taxable year. * * *

* * * * * *

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